Chartered Institute of Taxation
Excellence in Taxation

The Chartered Tax Adviser Examination

May 2019

Taxation of Owner-Managed Businesses

Advanced Technical Paper

TIME ALLOWED – 3 ¼ HOURS

- The first 15 minutes is designated as reading time. During this time you may read your question paper and legislation, annotate your question paper and use your calculator. You are not permitted to write in the answer booklet. The Presiding Officer will inform you when you can start writing.
- You should answer all **SIX** questions.
- Start each answer on a fresh page and do not write in the margins.
- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Marks are specifically allocated for presentation.
- Candidates who answer any law elements in this paper in accordance with Scots law or Northern Ireland law should tick the appropriate box on the front of each answer booklet.
- Unless otherwise indicated by the provision of additional table information, you may assume that 2018/19 rates and allowances continue to apply for 2019/20 and future years. Candidates referring to actual or pending rates and allowances for 2019/20 and future years will not be penalised.

1. You are a tax manager at a firm of Chartered Accountants.

Your client, Martin Goss, owns the entire share capital of Peters Ltd, a small building company. Martin formed Peters Ltd in 2009, investing £200,000 in share capital. The company has traded from its current premises, Unit 5, Albion Business Park, since 2015. Unit 5 was acquired on a 99-year lease using surplus funds arising from the company's trading activity. Previously, the company traded from Dalton Mill, which it continues to own. It was decided to retain Dalton Mill as an investment property and accordingly it was let under a 10-year full insuring and repairing lease at an annual rental of £25,000.

On 1 July 2019 Martin will give 49% of the shares in Peters Ltd to his daughter Helen, who is employed by the company as an administrator.

Your firm's share valuation specialist has valued a 49% interest in Peters Ltd at £700,000 and Martin's retained 51% interest at £800,000. He considers there to be no value in goodwill and the value of the company's tangible assets is considered to be equal to their book value.

Martin has asked for your advice on carrying out the transfer of the shares in the most tax-efficient way on the assumption that he makes no other disposals of chargeable assets in 2019/20.

The following is a summary of the company's accounts for the year to 31 December 2018.

Profit and loss account	£	£
Turnover – sales of houses		2,750,000
Cost of sales		(2,200,000)
Gross profit		550,000
Marketing and selling costs	125,000	
Administrative costs	250,000	
		(375,000)
Operating profit		175,000
Rental income		25,000
Interest payable		(45,000)
Profit (loss) on ordinary activities before taxation		155,000
Tax on profit on ordinary activities		(35,000)
Profit (loss) for the financial year		120,000

Balance sheet		
Fixed assets:		
Tangible assets		1,050,000
Stock and work in progress	650,000	
Debtors	125,000	
Cash at bank and in hand	150,000	
	925,000	
Creditors (amounts falling due within one year)	(200,000)	
Net current assets (liabilities)		725,000
Total assets less current liabilities		1,775,000
Provision for liabilities:		
Deferred taxation		(25,000)
Net assets		1,750,000
Capital and reserves:		
Called up share capital		200,000
Profit and loss account		1,550,000
		1,750,000

Continued

1. Continuation

You have made the following preliminary notes:

	£
Tangible assets includes:	
Leasehold property (Unit 5, Albion Business Park)	500,000
Freehold land and buildings (Dalton Mill)	400,000
Plant and machinery qualifying for capital allowances	150,000
	1,050,000
Cash at bank and in hand:	
Current account – used for working capital requirements	150,000

Requirement:

Write to Martin advising him of the Capital Gains Tax consequences of the proposed gift of shares in Peters Ltd to Helen and explaining any reliefs which may be available, including any relevant restrictions which may apply.

(15)

2. Your client, The Far Sight Partnership LLP, is a well-established Limited Liability Partnership of three individuals and three companies whose principal activity is the design and manufacture of spectacles and contact lenses. The LLP has historically prepared accounts to 30 June but in 2019 the accounting period was shortened to 31 March 2019.

For many years the LLP has operated from leasehold premises but in July 2018 as part of a significant expansion of the business, they purchased a freehold property. The previous owner had used the property as a production facility for their printing business.

During the period to 31 March 2019 the LLP incurred the following expenditure:

	Date	Expenditure £	Notes
Freehold property cost	20 July 2018	2,000,000	1
Removal and relocation of machinery from leased premises to new premises	August 2018	34,000	
New production machinery	October 2018	48,000	2
Construction of a sterile laboratory	January 2019	120,000	3
Solar panels	December 2018	29,000	
Air conditioning installed as part of the construction of new office space	August 2018	26,000	
Lighting systems	August 2018	8,000	4
IT equipment	November 2018	16,000	5
Two new computers	March 2019	7,000	5,6
Shelving, racking, desking etc.	October 2018	44,000	
Four new identical vans, £18,000 each	February 2019	72,000	7
Electric car	January 2019	69,000	8

Notes

1) The vendors stated that they had occupied the property from new in April 2000. Although they had claimed capital allowances on the purchase of machinery and equipment they had not claimed allowances on fixed plant. As part of the sale contract they undertook to cooperate fully with your client in order to maximise any available allowances for the LLP.

2) The production machinery is from a new supplier who has agreed that the LLP can take possession in October 2018 on payment of a 25% deposit. The balance being payable in 25% instalments due January, April and July 2019.

3) The laboratory is used exclusively by the LLP's research and development team.

4) The lighting system expenditure includes £2,200 on installing low energy light fittings throughout the building.

5) The IT equipment and computers will be replaced in four years' time.

6) One of the computers, which cost £3,000, is dedicated for use in the research laboratory.

7) The vans were acquired under Hire Purchase agreements signed in February 2019. On delivery one vehicle was found to be faulty and returned to the supplier. This was replaced by an identical vehicle in April 2019.

8) The electric car was acquired second hand and is used by the senior partner. Business use is 45%.

Continued

2. Continuation

9) The following disposals took place during the period to 31 March 2019:

	Date	Consideration received £	Notes
Scrap value of old machinery from the LLP's previous premises	June 2018	14,000	
Van	12 June 2018	0	10
Storage container	30 June 2018	6,750	11

10) The van was gifted to an employee as part of a termination package. The market value was £2,850.

11) The original purchase cost of the storage container was £5,500.

12) At 1 July 2018, the tax written down value brought forward was:

	£
General pool	108,000
Special rate pool	92,000

Requirement:

1) Calculate and explain the maximum capital allowances available to The Far Sight Partnership LLP based on the above expenditure but ignoring any allowances that may be found to be available on the purchase price of the property. (14)

2) Explain what action should be taken in order to maximise any allowances available on the purchase of the property. (6)

Total (20)

3. You are a manager in the tax department of a national firm of Chartered Accountants and are working with one of the partners in your firm on one of her clients, MK Construction Ltd.

MK Construction Ltd started trading in 2016 when its owners, Paul Hartley and Bill Martin, left their jobs at a large construction firm to research and develop innovative products to improve the energy efficiency of buildings. The company is a 'Small & Medium Enterprise' ("SME") for Research and Development purposes.

During the year ended 31 December 2018, the company and its staff worked on two projects:

Solid wall insulation

The current methods of insulating solid walls can be expensive and complicated to install, and therefore few homes have this insulation. This project involved research to determine whether any existing insulation products could be successfully used to insulate solid walls and overcome issues of damp and cost. The timeline for the project was:

Dates	Work carried out	Personnel involved
1 January 2018 to 31 January 2018	Market research	Marie Gilfillan
1 February 2018 to 31 March 2018	Research into the available methods of solid wall insulation	Paul Hartley Dave Graham
1 April 2018 to 31 August 2018	Testing of current products to determine failures, development and testing of new techniques to applying existing products	Paul Hartley Dave Graham Alice Swan Colin Campbell

Unfortunately, the company was unable to find any existing product or new method which could be applied to insulate solid walls without being prohibitive in terms of thickness or moisture retention and the project therefore ended on 31 August 2018.

Plant-based foam insulation

The company was sub-contracted by a local high-end house builder who is investigating whether it would be possible to develop insulation made of recycled plant materials, as opposed to the traditional fibreglass insulation used in houses. This had never been considered and involved significant development work and testing by MK as part of their customer's project. The customer is also an SME for Research and Development relief purposes.

The staff worked on this project during the months that they were not working on the project above. This project was still ongoing at 31 December 2018.

In addition to the above, general administration work accounted for 10% of each staff member's time, spread evenly across the year.

Continued

3. Continuation

Costs and company information

Bill, MK's finance director, has provided you with the following information in relation to the accounting period ended 31 December 2018.

	£	£
Turnover		362,956
Costs:		
Materials – plant-based foam project	94,737	
Materials – solid wall insulation project	125,945	
Other deductible costs of sale	89,557	(310,239)
Staff costs (including employer's NIC and pension) (Note 1):		
Paul Hartley	11,000	
Bill Martin	11,000	
Dave Graham	68,250	
Alice Swan	63,100	
Marie Gilfillan	38,050	(191,400)
Other costs:		
Consultancy – Centre Street Ltd (Note 2)	20,000	
Private medical insurance – Paul and Bill	1,400	
Rent, rates etc.	25,000	
Heat, light and power (Note 3)	10,000	
Other administration costs (all tax deductible)	16,534	(72,934)
Net profit/(loss)		(211,617)

Notes

1) All of the staff have worked for the company throughout the entire 12-month period.

2) Centre Street Ltd is Colin Campbell's personal company. Colin was hired by MK between 1 April 2018 and 31 August 2018.

3) Paul estimates that 30% of this cost relates to the solid wall insulation project and 40% relates to the plant-based foam insulation project.

Bill expects the company to make losses for the next few years, as it seeks to develop a marketable product. Cash flow is therefore extremely important to finance future research and development.

Requirement:

1) Explain whether each of the two projects discussed at your meeting would be likely to qualify for enhanced tax relief for Research and Development. (6)

2) Quantify the total amount of expenditure which the company could include in its Research and Development tax relief claim for the year ended 31 December 2018, along with brief explanatory notes. (9)

3) Explain the most appropriate method of obtaining a financial benefit for the company as a result of making the Research and Development relief claim and calculate the amount of this benefit for the year ended 31 December 2018. (5)

Total (20)

4. Your firm has recently been appointed as tax advisers to Softies Ltd, a company which trades as a bespoke software provider.

The ordinary share capital is currently owned by the following individuals:

Ethan Smith	45%
Jeff Hope	55%

Ethan is the company's managing director. Jeff is not an officer or employee of the company.

During the year ended 30 June 2018 the company advanced the following loans:

	£
Ethan Smith	60,000
Damien Jones	15,000

Damien is a senior employee and was granted an unapproved share option on 1 January 2018 to acquire new shares in the company which will represent 6% of the ordinary share capital. The option is exercisable on or after 1 January 2020.

The loan account movements included in debtors are as follows:

Ethan

	Notes	£
Loan advanced on 31 May 2018		60,000
Accrued interest @5% per annum	1	250
Balance at 30 June 2018		60,250
Repaid 31 March 2019	2	(60,000)
Further cash advance 20 April 2019		20,000
Balance at 30 April 2019		20,250

1) The company accrued one month's interest receivable at 30 June 2018 at a rate of 5% per annum. No interest has been settled by Ethan.

2) The repayment of the loan on 31 March 2019 was funded from dividends of £80,000 received by Ethan from shares held in another close company.

The loan was advanced to Ethan to cover personal credit card debts.

Damien

	£
Loan advanced on 6 April 2018	15,000
Balance at 30 June 2018	15,000
Repaid 31 March 2019	(15,000)
Balance at 30 April 2019	0

Interest payable by Damien was dealt with by a reduction in his salary of £500 in the tax year 2018/19. The loan was used to cover personal credit card debt.

Continued

4. Continuation

Borrowings

The company has recently expanded its business to include software data recovery services and this was funded by a loan from Jeff Hope of £100,000 made on 1 January 2019. The loan includes the following terms:

1) fixed rate of interest of 4% per annum, payable on calendar quarter-ends.

2) repayment on 31 December 2023.

Interest for the first quarter was paid by the company to Jeff on the due date of 31 March 2019. However, Ethan has advised Jeff that the company may be late settling the interest due on 30 June 2019.

Ethan has insufficient personal resources to repay the balance due on his loan account. The company is considering a formal waiver of the balance of the loan. Jeff has asked Ethan to obtain a summary of the tax implications of this proposal and other options that might be available to settle the loan.

Requirement:

Write a letter to Ethan explaining the tax consequences for the company and the individuals in respect of each of the loans. (20)

5. You are the tax manager responsible for Dudley Antiques Ltd, a company that has been trading as an antiques dealer since its incorporation in 1997. The company occupies a shop in Southwold on a short leasehold tenancy.

The company's sole shareholder and director, Angela Dudley, is 58 years old and has decided to dispose of her business and retire. The base cost of her shares is £50,000.

Angela has found a potential purchaser who is flexible on the arrangements for structuring their acquisition of her business.

Up to date financial information has been obtained on the assets and liabilities of the business:

	Balance Sheet £	Current value £
Fixed assets – net book value		
Lease	0	10,000
Fixtures and fittings	15,000	6,000
Office equipment	2,000	1,000
	17,000	
Stock	60,000	180,000
Trade debtors	4,000	3,000
Cash	7,000	
	71,000	
Trade creditors	(30,000)	
Corporation Tax	(50,000)	
	(80,000)	
Net assets	8,000	
Goodwill	Nil (cost)	400,000
Total		600,000

An offer of £600,000 has been made for the trading assets. Alternatively, the purchasing company is willing to acquire the entire share capital of Dudley Ltd for £500,000. The amounts offered are non-negotiable.

The landlord of the Southwold shop has agreed that the lease can be assigned by Dudley Antiques Ltd. No premium was paid for the lease.

The company has:

1) Capital losses of £5,000 brought forward.
2) Nil balances on the special rate and main capital allowances pools.

Angela is considering providing valuation consultancy services to local antique dealers in Yorkshire and may also occasionally sell antique items through an online marketplace.

Angela satisfies the conditions for the ownership of shares in a "personal company" and has not previously claimed entrepreneurs' relief.

Angela has no capital losses and has used her annual exemption for 2019/20.

On retirement, Angela's taxable income will be covered by her personal allowance. Angela has reached her personal lifetime allowance limit for pension contributions.

Requirement:

Write a letter to Angela advising on the disposal of her business. (15)

6. You are a tax manager in a small, regional firm of tax advisers. Your colleague, who has recently started her career in tax, is preparing the 2018/19 tax computation for Ollie Johnston, a sole trader client of your firm. She has sent you the email below, querying the tax treatment of a number of expenses included within Ollie's accounts for the year ended 31 March 2019.

To: Bob Moore
From: Hayley Mills
Date: 30 April 2019
Subject: Ollie Johnston tax return

Hi Bob

I am unsure how to treat the expenses below in Ollie Johnston's tax computation and would appreciate your assistance.

<u>Property repairs</u>

Ollie spent £15,000 on 30 November 2018 having part of his business's office renovated. As the wall at the rear of the office was suffering from damp, which would have cost £3,500 to remedy, Ollie had the wall removed and had a small extension constructed, which is now used as meeting space.

<u>Services for own use</u>

Ollie used one of the business's web designers to design a website for his daughter's new business. This took the designer 25 hours to create and he is paid an hourly rate of £35. Ollie would have charged a customer £2,500 for the creation of the same website, however he only charged his daughter £100.

<u>Training costs</u>

Ollie has included costs of £5,600 in his accounts for the year in respect of training costs. Of this, £4,000 relates to Ollie and an employee both going on a series of training courses to complete an introductory qualification in digital marketing, a new line of business that Ollie subsequently commenced in this period. The other £1,600 consists of monthly technical update seminars which are attended by all of the staff, and Ollie.

<u>Gift to employee</u>

Ollie gave one of his staff a department store gift voucher worth £50 on the occasion of her wedding. This has been accounted for within sundry expenses of the business.

Thanks

Hayley

Requirement:

Draft a reply to your colleague, explaining the tax treatment of each expense. (10)